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Primer On Reserve Requirements

By William Burke

The Federal Reserve Board of Governors has proposed extending the present system of reserve requirements to nonmember institutions—including both banks and thrift institutions—to the extent that such institutions issue deposits that perform any type of checking-account function. This report presents, in question-and-answer form, a discussion of this subject. It begins with a summary of the Federal Reserve proposals, followed by some historical background and a discussion of the monetary-policy uses of reserve requirements. The report continues with an analysis of the Fed's supporting arguments, and concludes with a discussion of some opposing views.

The basic function of reserve requirements is to permit the Federal Reserve to control the supply of money and credit in pursuit of its basic economic-policy goals. Reserve requirements can influence the growth of bank loans, investments and deposits, and thus are an important element in the monetary-control mechanism. To permit proper central-bank management of the supply of money and credit, banking institutions should meet their reserve requirements by holding assets in a form which is under the most direct control of the Federal Reserve. These assets could be either vault cash (coins, Treasury currency, Federal Reserve notes) or deposits at the Reserve Banks.

This test cannot be met by present state legislation. Under such legislation, nonmember banks may be subject to similar percentage ratios but are not required to hold reserves in the form of deposits at Federal Reserve Banks; instead they may hold those reserves in other forms, such as correspondent balances with other commercial banks. When such reserves are held at a member bank, that bank naturally must support these balances with its own reserves consisting either of vault cash or deposits at the Federal Reserve, but the size of its cash reserves will be only a fraction of the initial deposit at the nonmember bank.

With present differential reserve requirements, therefore, shifts of deposits between member and nonmember banks alter the quantity of deposits at all commercial banks that can be supported by a given volume of bank reserves. This factor tends to loosen the links between bank reserves and the money supply, and weakens the Fed's control over the monetary aggregates. The problem is complicated by the sharp fluctuations and rapid growth of nonmember-bank deposits. Over the past decade, nonmember banks have accounted for roughly 40 percent of the total rise in checking deposits, but the proportion has varied in individual years from as low as one-tenth to as high as three-fourths or more. Since 1960, moreover, the nonmember-bank proportion of total demand deposits has risen from 17 to about 25 percent, and it may well continue to rise.

The growing importance of nonmember banks mainly reflects the competitive disadvantage imposed on member banks by requiring them to hold reserves in the form of vault cash or as deposits at the Federal Reserve. Non-member banks, in contrast, can utilize required reserves as earning assets even when they are held as demand balances with other commercial banks, since these balances also serve as a form of payment for services rendered by city correspondents. As a consequence, banks generally have an incentive to avoid membership in the Federal Reserve System. Since 1960, about 750 banks have left the System through withdrawal or mergers, and almost 1,800 newly chartered state banks have remained outside, compared with less than 100 that elected System membership. (Over the same period, there have been about 870 newly chartered national banks, and these automatically have become Federal Reserve members.) The subject gains new urgency because of the recent efforts of nonbank deposit institutions to evolve new modes of money transfer, since this factor could further loosen the linkages between reserves and the money supply.

Provisions of Proposed Legislation

What is the Federal Reserve's basic proposal?

The Federal Reserve proposes to extend the present system of reserve requirements to nonmember institutions, to the extent that such institutions issue deposits that perform any type of checking-account function.

What types of deposits would be included or excluded?

Reserve requirements would be applied only to nonmember accounts which are directly employed in making money payments—that is to demand deposits and to time accounts with negotiable third-party payment features. The proposal would not apply to nonmember time deposits other than negotiable orders of withdrawal—NOW accounts, that is, interest-bearing deposits for which the depositor can make withdrawals by negotiable or transferable instrument. Regular time-and-savings deposits would not be included because they are not highly active deposits, although they do serve a money-like function, to some degree.

What would the new requirements be?

The reserve-requirement range would be between 5 and 22 percent for demand deposits, with the specific figure determined, just as now, by the Federal Reserve Board of Governors. (The present range is from 10 to 22 percent at reserve city banks and from 7 to 14 percent at other banks.) The range would be between 3 and 20 percent of NOW accounts. In addition, the range for member-bank time-and-savings deposits would be changed from the present 3 to 10 percent, to a range of 1 to 10 percent.

What institutions would be affected?

The proposal would apply to commercial banks, of which there are about 5,700 member and 8,300 nonmember institutions. It would also apply to savings and other depository institutions, along with foreign-owned banking institutions that provide demand (checking account) deposits. The reserves would be held in the form of vault cash or non-interest-earning deposits at the Federal Reserve. The legislation would not require System membership on the part of present nonmember institutions, nor would it make any change in supervisory arrangements.

What exemptions are included in the proposal?
The draft legislation includes a provision which effectively exempts the first $2 million of net demand deposits and NOW accounts from reserve requirements. The average size of nonmember bank that would be totally exempted would be about $4 million, for total time and demand accounts. Such institutions number about 3,000, but they hold only about 2½ percent of the nation's total demand deposits. Altogether, about 62 percent of the present nonmember banks—over 5,000 banks in all, controlling roughly 6 percent of deposits—would be exempt from any reserve requirements that exceed their present vault-cash holdings.

When would the new reserve requirements be imposed?
To ease the transition, required reserves would be phased in gradually over a four-year period, on those deposits (over $2 million) held at the time the law goes into effect. The phase-in would occur at the rate of 20 percent of the total requirement per year, so that by the fifth year each bank would be meeting its full reserve requirement. However, any increase in deposits over those existing at time of enactment would be immediately subject to the full reserve requirement.

What benefits would nonmember institutions receive under the Fed's proposal?
The legislation would permit Federal Reserve credit to be made available to any institutions that maintain deposits with Reserve banks, subject to existing Federal Reserve regulations. Under present law, credit to nonmembers is extended only in highly unusual circumstances, and under restrictive conditions as to the type of collateral that may be accepted by the Reserve Bank. The proposed legislation would give nonmember institutions greater access to the Fed's discount window, especially at times of strong pressures on their liquidity positions.

What reporting arrangements would be required?
The legislation would require reporting of deposit liabilities by institutions (member and nonmember) that are subject to reserve requirements set by the Federal Reserve. This information, which is needed for monitoring purposes, would permit comparative analysis of the various financial institutions as the proposed reserve structure goes into effect.

Historical Background of Reserve Requirements

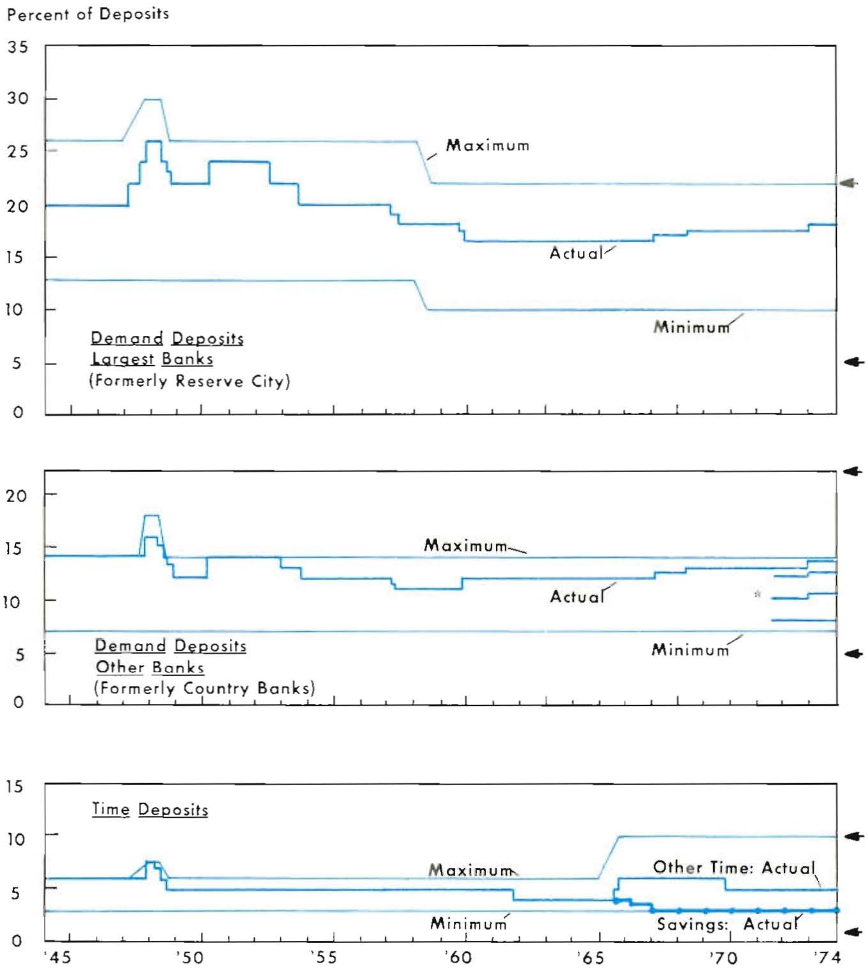
What was the original purpose of reserve requirements?
Before the Federal Reserve System was founded, reserve requirements were imposed by legislation at the national and state levels as a means of protecting bank liquidity. That philosophy was reflected in the original structure of reserve requirements adopted by the Federal Reserve.

Are reserve requirements still used as a means of protecting liquidity?
Required reserves are no longer a source of operating liquidity, except as they can be used within the weekly reserve-accounting period to absorb large fluctuations in check clearings. Instead,

the essential function of reserve requirements today is to serve as a fulcrum for monetary policy. Paradoxically, the assets now called "bank reserves" do not serve as additional resources for paying off withdrawals except in a minor way. (They can furnish a fraction of the funds needed, depending on the reserve ratio; for example, with a 10-percent ratio, 10 percent of the funds are provided through excess reserves as required reserves fall.) On the other hand, the additional resources which banks actually hold to meet withdrawals—their reserves in a functional sense—are not called reserves.

What resources do banks have to meet customer demands for withdrawals?

Banks can draw on their liquid assets; these include reserve-account balances at the Fed held in excess of requirements (with the proviso noted above), plus their own deposits at other banks and readily marketable short-term assets from their loan and security portfolios. Additionally, banks usually have other sources of funds: from other banks in the form of inter-bank loans, from the public in the form of interest-bearing CD's, and from the Fed through the discount window if they are Federal Reserve members. (Nonmember banks may



←Arrows indicate minimum and maximum requirements under Federal Reserve proposals.

*Regulation D amendments (Nov. 1972) introduced graduated reserve requirements with lower requirements for smaller categories of banks.

Reserve requirements generally have trended downward over the past twenty years

borrow from the Fed only under certain emergency provisions of the Federal Reserve Act.)

What member-bank liabilities are subject to reserve requirements?
Legal reserves are required against the following member-bank liabilities: net demand deposits (gross demand deposits less cash items in process of collection and balances held with other banks); savings deposits; other time deposits, defined as deposits maturing in 30 days or more; liabilities to foreign branches, borrowings from foreign banks, and assets acquired by foreign branches from their domestic offices; and funds obtained by member banks via the issuance of commercial paper or similar obligations by their affiliates.

What has been the historical trend of reserve requirements?
Present reserve percentages have evolved from about 40 separate changes since the Federal Reserve System was established. Perhaps by coincidence, today's percentages are not greatly different from the original levels. (Depending on size of bank, requirements now range from 8 to 18 percent on demand deposits, and from 3 to 5 percent on time deposits, while marginal requirements of 8 percent are imposed on large time deposits and related money-market instruments.) However, reserve requirements generally have trended downward over the past twenty years. Since 1953, requirements on net demand deposits have been reduced on balance by about 6 percentage points for both large and small banks. Average requirements on time-and-savings deposits are lower now than twenty years ago, with requirements on savings deposits being at their statutory 3-percent minimum (see chart).

What about the geographic differentiation of reserve requirements?
This geographic differentiation was a holdover from the National Banking Act, which viewed required reserves as a source of liquidity. Interbank deposits were extremely volatile and were concentrated in the larger cities, so banks located there were subject to the highest reserves. But with the passage of time, this system of reserve classification became increasingly outmoded. Some large banks in cities of substantial size enjoyed the lower reserve requirement applicable to country members, while some small banks in major financial centers had to carry the higher reserve requirement imposed on reserve city members. To end this anachronism, in 1972 the Federal Reserve introduced reforms so that all member banks of a given size, whatever their location, were subject to identical reserve requirements.

What about reserve requirements on nondeposit sources of funds?
Such requirements date back to the tight-money period of 1969. In that year, and earlier in 1966, market rates of interest rose above the ceiling rates payable on time deposits under the Fed's Regulation Q, so that investors switched their funds out of deposits into bonds and other market instruments. But Euro-dollar borrowings and commercial paper sold by bank-holding companies provided avenues through which banks could bid for funds to offset deposit outflows, since they had never been subject to Reg Q ceilings. Consequently, in 1969 the Federal Reserve imposed reserve requirements on additions to Euro-dollars, and in 1970 it imposed requirements on bank-related commercial paper, in order to close off those sources of loanable funds and thereby slow the expansion of bank credit. For similar anti-inflationary reasons, the Fed last year imposed marginal reserve requirements on increases in funds obtained through CD's or holding-company paper.

What types of reserve requirements are imposed on nonmember banks?

State-chartered nonmember banks must abide by the regulations of their respective states with regard to reserves. Since each state authority sets its own rules, there are actually 50 sets of reserve requirements in addition to that of the Federal Reserve System. (Federal deposit-insurance legislation in 1933 in effect imposed uniform reserve requirements through uniform System membership, but this provision was later repealed.) Most states have reserve-requirement percentages nominally similar to the Fed's; demand-deposit requirements in 33 states are equal to (or greater than) those the Fed imposes on a medium-to-large bank. However, nonmember banks often have more options than member banks in meeting reserve requirements, and these options tend to lessen or even eliminate their cost burdens. Nonmembers hold a greater percentage of their assets in a form that earns interest or buys services; some states permit holdings of U.S. Treasury or municipal securities to count as reserves, and most states permit use of demand balances at city correspondents, whether or not the deposited funds have been actually collected. Thus, nonmembers can obtain a competitive edge over member banks and can be inherently more profitable.

How do member and nonmember requirements compare in this District?

In four District states (California, Nevada, Utah and Washington) state reserve-requirement ratios on demand and time deposits are almost identical to those of member banks. (In these and other states, of course, state nonmember banks have more options than member banks concerning the form in which reserves may be held.) In three states (Arizona, Hawaii and Oregon) state reserve requirements on demand deposits are generally lower. Arizona and Oregon also maintain a 4-percent rate on all savings-and-time deposits, versus 3-percent and 5-percent rates, respectively, for member banks. Alaska's state requirements are higher for both demand and time deposits. Idaho generally maintains higher reserve requirements against demand deposits.

What types of reserve requirements are imposed on thrift institutions?

The Federal Home Loan Bank System, which covers about three-fourths of all savings-and-loan associations, imposes a reserve requirement on its members. State-chartered S&L's in 16 states, and state-chartered mutual-savings banks in 8 states, also are governed by similar sorts of requirement. However, the requirements affecting thrift institutions are designed solely to further institutional liquidity, and generally take the form of cash, deposits with banks, and government securities. Since a rigid reserve requirement provides virtually no usable liquidity, the Home Loan Bank Board tends to vary the ratio according to conditions, lowering it in periods of tight money and increasing it when easier credit conditions prevail. Thrift institutions' liquidity reserves generally equal or exceed the Fed's reserve-requirement ratios on time deposits, although again, there are differences concerning the form in which reserves may be held.

How does the U.S. differ from foreign countries in its reserve requirements?

The United States was the first country to formalize the traditional cash reserves of commercial banks into a set of legally required reserve ratios. Today, however, the U.S. is the only major industrial country that splits the responsibility for setting reserve requirements between the central bank and regional banking authorities. It is the only major country that does not grant the central bank the power to regulate reserves of nonbank depository institutions, even though most savings and other time deposits are kept with such institutions. In addition, no other major country makes central-bank affiliation—and compliance with its reserve regulations—voluntary for a significant part of the commercial-banking community.

How have reserve requirements evolved abroad?

Legal reserve requirements did not become part of most foreign-banking legislation until World War II and the early postwar years. Some leading countries, such as Great Britain and France, introduced reserve requirements only a few years ago; in fact, the Bank of England continues to rely on voluntary compliance with the ratios it sets. However, those two countries have used reserve ratios decisively in recent years to deal with inflationary pressures. In Germany, reserve requirements have become a main tool of monetary control in the past several decades.

What has been the recent foreign experience?

Major foreign countries, like the U.S., have recently experienced changes in financial structure and in the channels of credit flows, as well as in the scope of activity of various credit-granting institutions. These changes have resulted in successive extensions in the range of liabilities and in the range of institutions subject to reserve requirements. Over time, reserve requirements have been imposed on additional types of institutions that begin to accept deposits or that become important factors in the short-term credit market. Moreover, some countries which typically gain nonresident deposits during international crises have imposed higher reserve ratios (sometimes marginal requirements) on such deposits.

Reserve Requirements as a Policy Tool

What is the basic function of reserve requirements?

The basic function is not to ensure bank liquidity, but rather to permit the Federal Reserve to control the supply of money and credit in pursuit of its basic economic-policy goals. Reserve requirements provide a known and controllable base through which the reserve-supplying and reserve-absorbing actions of the Federal Reserve can affect the supply of money and credit. This mechanism operates through the Federal Reserve's control over the percentage of deposits that must be held as reserves, in the form of either vault cash or balances at Reserve Banks, and through its influence (via open-market operations) over the total amount of member-bank deposits.

How do changes in reserve requirements tend to operate?

The Federal Reserve's control over the level of total deposits is exercised predominantly through its open-market purchases and sales of government securities. Open-market operations create or destroy reserves, and in a fractional-reserve system, these actions in turn cause a multiple expansion or contraction of deposits, based on the reciprocal of the required deposit ratio. But, in addition, instead of changing the amount of reserves available to the banks, the Fed can simply change the amount of deposits each dollar of reserves will permit. This is done, of course, through changes in reserve requirements. For example, with a 16-percent reserve requirement (roughly a 6-to-1 ratio) each dollar of reserve balances permits the issue of about six dollars in deposits. With a change in the requirement to 14 percent (roughly a 7-to-1 ratio) each reserve dollar permits about seven deposit dollars, thereby raising the total deposit limit to about 7/6 of the former level.

Could reserve requirements play a larger role?

Some observers have proposed an increased use of the reserve-requirement tool, through the device of frequent small percentage changes in such requirements. However, the experiment hasn't been tried because of the overall effectiveness of open-market operations for implementing policy objectives. (Incidentally, the revival of monetary policy over two decades ago was closely linked to the availability of the weapon of open-market operations, since the public debt was large and widely distributed and was comprised largely of marketable securities with a wide range of maturities.) Still, the reserve-requirement tool has the advantage of permitting monetary policy to affect the reserve position of all banks immediately, thereby permitting a prompt change in bank-credit availability. With uniform reserve requirements, this tool could be utilized more frequently as an instrument of policy.

When have reserve-requirement changes been utilized?

The actual use of reserve requirements has varied with monetary conditions and with prevailing policy views. Some of the most notable episodes were the sharp (and widely criticized) increase in requirements in 1936-37 to mop up excess liquidity, the successive reductions at large banks in 1942 to facilitate bank absorption of war loans, the modest increases in 1951 to offset the Korean War's expansionary impact on bank credit, followed by gradual reductions from 1953 to 1966 to meet the general criticism of the high level of such requirements. Increases in 1968, 1969 and 1973 were made in an effort to curb inflationary pressures.

Are differential requirements valid, as between demand and time deposits?

Demand deposits are part of the money supply and are closely associated with the volume of spending, and fluctuations in such deposits are generally presumed to have a greater impact on economic stability than fluctuations in time deposits. Differential requirements thus serve to neutralize somewhat the impact on economic activity of shifts between demand and time deposits.

Should reserve requirements be maintained at all on time deposits?

The answer depends on one's viewpoint regarding the crucial monetary aggregate: M_1, defined as demand deposits (other than U.S. Government and domestic interbank deposits) plus the non-bank public's currency holdings; M_2, defined as M_1 plus commercial bank time deposits (other than large CD's); or M_3, defined as M_2 plus thrift institution deposits. The M_1 advocates feel that the monetary authorities need control only demand deposits. The M_2 advocates believe that the level required against bank time-and-savings deposits should be very close to that imposed on demand deposits. The M_3 advocates believe that thrift institutions should be subject to the same requirements as banks—certainly so if they should begin to offer demand-deposit liabilities. The Fed's view is that some reserve requirement on at least bank time deposits is appropriate, since these deposits are a partial substitute for money and an important source of loanable funds. However, if changes in time-and-savings deposits are small or easily predictable, then the matter is relatively unimportant from the standpoint of monetary policy.

Arguments Supporting Federal Reserve Proposal

What is the basic principle underlying the Fed's proposal?
The principle is that equivalent cash reserve requirements should apply to all deposits that effectively serve as part of the public's money balances.

What are the two major issues involved in this controversy?
The first is the need to provide a more equitable system of reserve requirements for financial institutions offering similar deposit services. The second is the need to facilitate the management of monetary policy by sharpening one of the principal policy tools.

Why is the present system inequitable?
The inequity lies in the differential cost burdens associated with the types of assets that may be counted as reserves by the various types of banks. Member banks must maintain their reserves in the form of either vault cash or deposit balances at Federal Reserve Banks. Nonmember banks have more options in meeting their reserve requirements, and these options tend to lessen or even eliminate their cost burden. For example, 10 states permit use of interest-bearing U.S. Treasury or municipal securities, and 45 states permit use of demand balances at city correspondents, to meet at least part of nonmember-bank reserve requirements. (State laws allow uncollected balances to be counted as legal reserves, and these balances alone amount to about 8 percent of demand deposits, or roughly half of average reserve requirements.) Because nonmembers hold a greater percentage of their assets in a form that earns interest or buys services, they have a competitive edge over member banks and thus can be inherently more profitable.

Why does the present system complicate monetary-policy formulation?
To achieve good management over the supply of money and credit, reserve requirements must be met by holding assets which are outside the payments stream and whose aggregate volume is under Federal Reserve control. Reserve requirements set by the various states do not meet this test. Nonmember-bank holdings of interest-bearing securities or of deposits with other banks fail to contribute to the monetary-policy function of reserves, since the funds so used remain available to finance additional deposit and credit expansion. When a nonmember bank satisfies all or part of its state reserve requirement by holding deposits at a member bank, that member bank naturally is required to hold cash reserves against these deposits at a Federal Reserve Bank or in its own bank vault. But in this case, the size of the member bank's cash reserve is quite small relative to the initial deposit at the nonmember. Consequently, the task of monetary control is complicated by the minor degree to which nonmember deposits are indirectly backed by reserves that satisfy Federal Reserve reserve requirements.

Could a shift toward nonmember banks further complicate the problem?
Shifts in deposits between member banks and nonmembers alter the relationship between reserves under Federal Reserve control and the nation's deposits. During an inflationary period, for example, the Fed generally attempts to restrain monetary growth by providing bank reserves at a reduced pace. However, its efforts may be offset if the public is at the same time shifting deposits into nonmember banks, thereby leading to a faster growth of deposits and the money supply than would be expected from the slower growth of member-bank reserves. Deposits at nonmember institutions require less cash reserves than at member banks, so

that the total of deposits that would be supported by the available total of cash reserves would be enlarged.

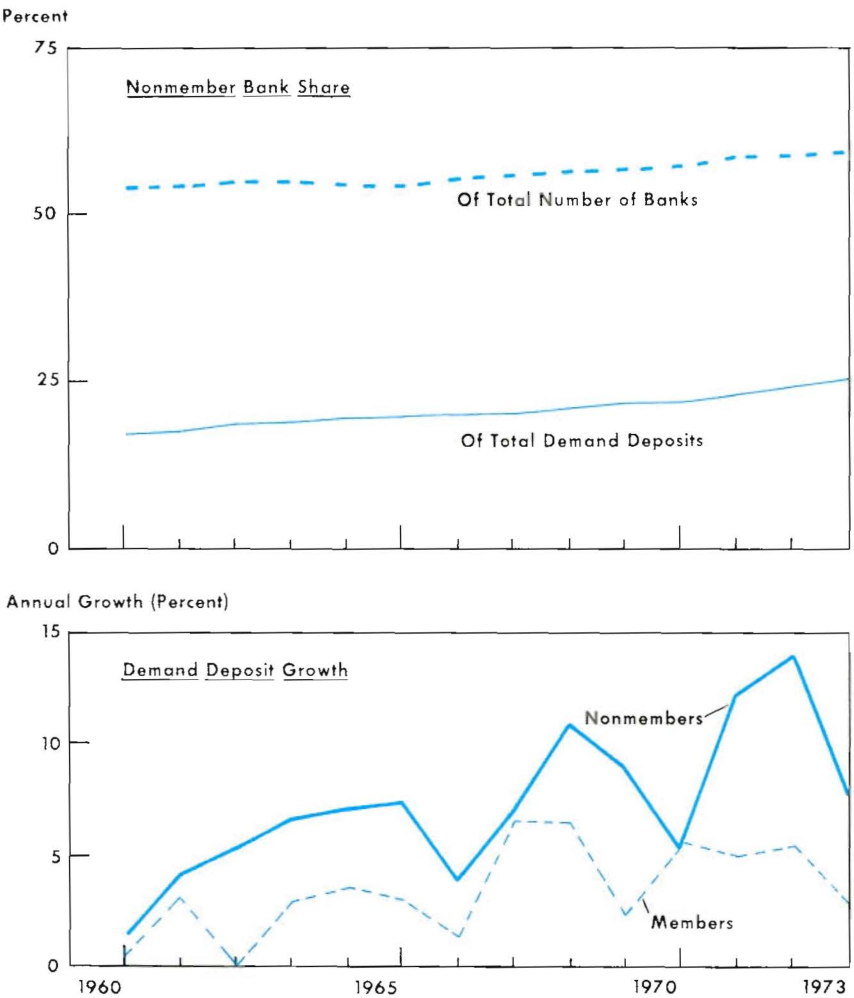
Has a shift of this type actually occurred?
The nonmember-bank proportion of demand deposits has been rising over the past decade and a half, from 17 percent of the total in 1960 to about 25 percent of the total in 1973. This has come about because of a 164-percent increase in the demand-deposit component of the money supply held at nonmember banks, compared with a 61-percent growth at member banks. Also, deposit growth at nonmembers has shown more year-to-year fluctuations than at member banks, thus compounding the difficulties of monetary control under the prevailing deposit structure (see chart). In terms of numbers of banks, about 750 banks have left the Federal Reserve System through withdrawal or mergers since 1960, while less than 100 of the roughly 1,850 newly chartered state banks have elected to join the System over that period.

What accounts for the rapid growth of the nonmembers?
This trend partially reflects the rapid population growth in regions of the country served by nonmember banks. But a major causal factor is the competitive disadvantage imposed on member banks by being required to hold reserves as vault cash or as deposits at the Federal Reserve Bank. Banks must forego earning assets to build up a reserve balance at the Federal Reserve. That reserve balance pays no interest, although member banks do receive some services from the Federal Reserve.

Why does the present system hamper the use of the reserve-requirement tool?
The Federal Reserve must use changes in reserve requirements sparingly as an instrument of monetary policy, since an increase in requirements would worsen the competitive disadvantage of member banks and thereby threaten a further erosion of membership. This inhibition has been unfortunate, for there have been times when the prompt and pervasive impact of a higher reserve requirement would have been the best way to signal a policy move toward added restraint on credit availability.

Have reserve requirements actually been raised during inflation periods?
Twice during the late 1960's, this weapon was utilized as an anti-inflationary move. Again, last year, the System raised requirements on demand and certain time deposits, and also appealed to nonmember banks to cooperate by voluntarily increasing reserves in a like amount. The three increases in demand-deposit requirements over the past half-decade—½ percentage point each time—have brought the requirement for the largest banks to 18 percent. Given the severity of the inflation, however, requirements for large money-center banks might have been raised more frequently, or brought closer to the 22-percent maximum, if there had been no constraints on Federal Reserve actions in this area (see chart).

Why does the present system hamper the precision of policy formulation?
Monetary-policy formulation is based increasingly on such key monetary aggregates as the M_1 money supply, yet the lack of current nonmember-bank data makes it impossible to obtain a precise measure of this key statistical series. The latest revision, which changed the 1973 growth rate for M_1 from 5.0 to 5.7 per-



Nonmember-bank proportion of total demand deposits rises from 17 to 25 percent since 1960

cent, was caused mostly by the largest nonmember benchmark adjustment in the history of the series. (This factor alone added \$2.8 billion to the level of M_1 for both June and October benchmark dates.) There are only infrequent single-day observations, two to four times a year, of nonmember-bank deposit data. But demand deposits are highly volatile, especially on a day-by-day basis, so that money-supply measures can be distorted by single-day relationships between member and nonmember banks. The situation is complicated by the size and rapid growth of the nonmembers' deposit share.

Should reserve requirements be extended to certain thrift-institution deposits?

Mutual-savings banks in New Hampshire and Massachusetts offer depositors interest-earning accounts subject to a "negotiable order of withdrawal"—in effect, an interest-bearing checking account. Savings-and-loan associations in California are attempting to enter the electronic money-transfer system operated by the California Automated Clearing House. These innovations probably represent the first step toward what ultimately will become a single, integrated nationwide payments system—and they raise the question of how the costs of such a system can be equitably distributed among all the institutions involved. If thrift institutions develop extensive checking powers and become part of the newly emerging payments mechanism without assuming a proportional share of the costs, the present member-nonmember inequities would only be increased.

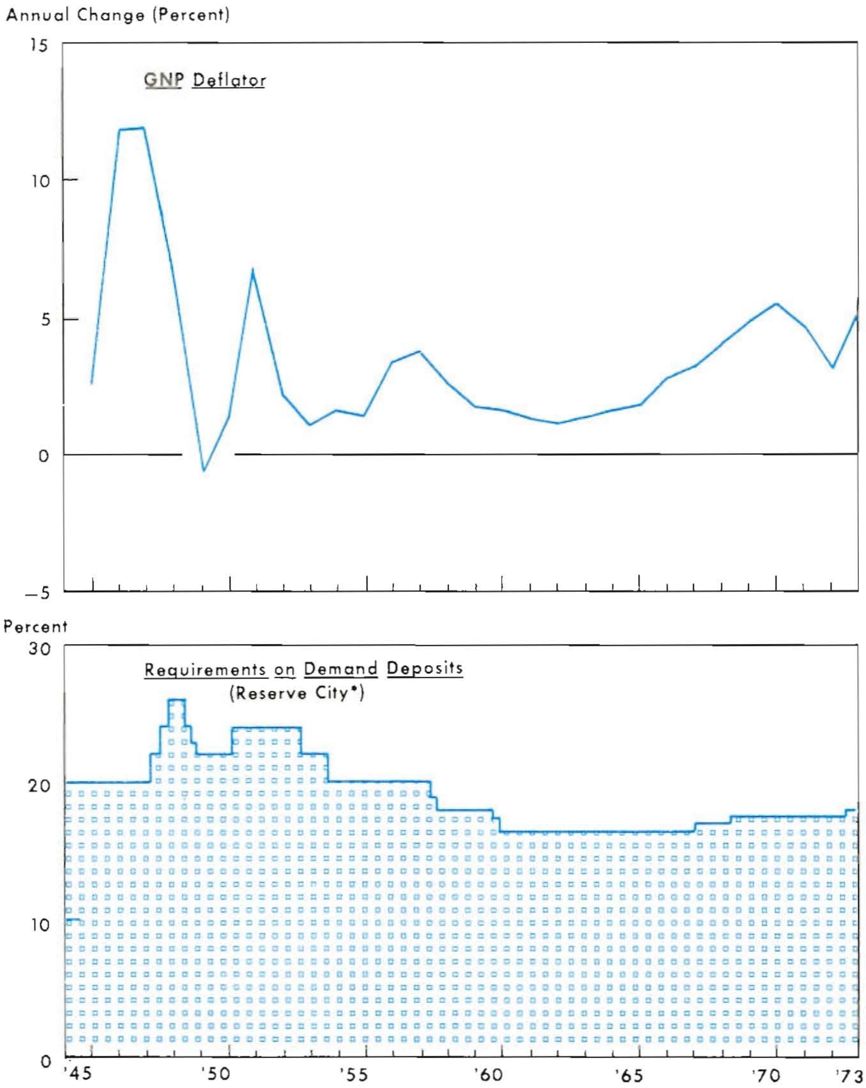
Should uniform requirements be imposed on bank and nonbank time deposits?
From the viewpoint of equity, a case can be made for uniform reserve requirements on time-and-savings deposits at all financial institutions. At the same time, it should be remembered that the diversified services offered by commercial banks give them an advantage in bidding for such deposits, even after taking into account their costs of holding cash reserves. Given the continuation of recent trends, however, the increasing provision of money-transfer services by nonbank thrift institutions will blur the distinction between the two sets of institutions, just as it blurs the distinction between checking and savings accounts. As nonbank institutions become more like commercial banks, the basis for difference in reserve requirements will be weakened.

Opposition to Federal Reserve Proposal

What are some of the major sources of opposition to the proposal?
Nonmember banks and financial institutions tend to oppose the proposal, because they would lose their present competitive advantage if forced to operate under Federal Reserve requirements. Some member banks also are doubtful, because they are afraid of losing a considerable volume of correspondent-bank balances. In addition, some financial institutions and regulatory authorities are afraid that the proposal would lead to universal Federal Reserve membership, although the Fed categorically rejects this view, and specifically includes widespread exemptions with the reserve-requirement proposal.

Is the proposal unnecessary from the standpoint of monetary-policy formulation?
Opponents frequently quote a statement by Federal Reserve Governor Mitchell, to the effect that reserve requirements are a "desirable and convenient, but not absolutely indispensable" tool of monetary control. This statement supports the widely accepted view that the Federal Reserve can influence monetary aggregates and bank credit sufficiently by relying solely on open-market operations and the discount window. But the rest of Governor Mitchell's statement, which opponents generally ignore, states, "to do so would place a heavier burden on financial markets, and would forfeit the advantages of immediacy and pervasiveness inherent in a general change in reserve requirements." Moreover, the reporting aspects attendant to the Fed's proposal will ensure the availability of more precise monetary statistics.

On equity grounds, should reserve requirements be eliminated completely?
From the standpoint of equity—that is, equal treatment of all financial institutions—the same result could be achieved by imposing uniform reserve requirements or by eliminating requirements completely. Proponents of the latter view argue that reserve requirements act as a tax-like penalty on bank earnings, and thus should be discarded. However, elimination of this "tax" would result in an inordinate increase in the level of bank profits and a consequent windfall gain to bank stockholders, which could be difficult to defend.



*Central Reserve City prior to 1962

Problem of member-bank erosion tends to restrain Fed from raising reserve requirements during recent inflation

On equity grounds, should interest be paid on required reserves?

Since reserve requirements are, in effect, an excise tax which currently discriminates among institutions, a case can be made for paying some interest return on required reserves as a means of offsetting this "tax." The alternative, however, is to end the discrimination by extending the scope of the "tax" through uniform reserve requirements. Adoption of this alternative approach appears more urgent because of the strength of the Fed's arguments for uniform requirements. Moreover, if banks did receive an interest return on their required reserves, they could then be called upon (on grounds of symmetry) to pay interest themselves on their Treasury tax-and-loan accounts and even on their demand deposits.

Would the proposal destroy the dual-banking system?

Opponents of the proposal claim that it would erode or even destroy the dual-banking system of state and national supervision. This is the system which, in the words of the Conference of State Banking Supervisors, "stimulates banks to meet local needs through its contribution to bank flexibility and its innovative qualities in a constantly changing economy." It is alleged that state nonmember banks are hampered by state laws and regulations, which tend to offset their cost advantage stemming from easier reserve requirements, and that loss of this cost advantage would induce them to switch from state to national charters. State-chartered nonmember banks are supervised by state banking authorities and the FDIC; nationally-chartered banks must be members of the Federal Reserve System, and they are regulated by the Comptroller of the Currency. Thus, it is argued that a wholesale shift from state to national charters could lead to the demise of the dual-banking system. In rebuttal, it should be noted that the proposed legislation exempts most small banks, which are predominantly nonmembers, from uniform reserve requirements. The exemption of institutions with $2 million or less in net demand deposits and/or NOW accounts frees 62 percent of present nonmember banks—over 5,000 banks—from reserve requirements in excess of existing vault cash holdings.

Would the proposal destroy correspondent-banking relationships?

Opponents of the proposal point out that if nonmember banks were required to place reserves with the Fed, funds would be transferred by nonmembers from their correspondent accounts to Federal Reserve Banks. Since member banks' demand-deposit balances with their correspondents amount to relatively only half as much as nonmember-bank balances, compliance with the Fed's proposal could lead correspondent banks to lose perhaps half of their present $10 billion in nonmember accounts, according to the Conference of State Bank Supervisors. A reduction of correspondent balances of this magnitude would sharply reduce profits derived from providing correspondent services, and would thus curtail the availability of such services and compel banks generally to rely on the Fed for an increasing proportion of correspondent-type services. In rebuttal, it should be noted that correspondent banks have consistently maintained profitable relationships with member banks as well as nonmembers. They could perhaps lose some business under the Fed's proposal, but in view of the exemption provision, certainly nothing of the magnitude suggested above. In particular, large correspondent banks furnish services —portfolio analysis and advice, assistance in international transactions, loan participations, and so on—that Reserve Banks do not and should not provide.